

**LETTER FROM THE AUDITOR OF PUBLIC ACCOUNTS
KENTUCKY DEPARTMENT OF REVENUE**

**In Reference to the Statewide Single Audit
of the Commonwealth of Kentucky**

**For the Year Ended
June 30, 2006**



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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

To the People of Kentucky
Honorable Ernie Fletcher, Governor
John Farris, Secretary, Finance and Administration Cabinet
Department of Revenue

MANAGEMENT LETTER

KRS 43.090 (1) requires the Auditor of Public Accounts, upon completion of each audit and investigation, to prepare a report of all findings and recommendations, and to furnish copies of the report to the head of the agency to which the report pertains, and to the Governor, among others. This KRS also requires the Department of Revenue to, within 60 days of the completion of the final audit, notify the Legislative Research Commission and the Auditor of Public Accounts of the audit recommendations it has implemented and those it has not implemented and any reasons therefor. We are providing this letter to the Department of Revenue in compliance with KRS 43.090.

The work completed on the Department of Revenue is part of the overall opinions included in the audit of the Commonwealth of Kentucky's Comprehensive Annual Financial Report (CAFR) and Statewide Single Audit of Kentucky (SSWAK). Findings and recommendations for agencies, audited as part of the CAFR and SSWAK, if applicable, can be found in the Statewide Single Audit Report. This report can be obtained on our website at www.auditor.ky.gov.

In planning and performing our audits of the Commonwealth for the year ended June 30, 2006, we considered the Department of Revenue's internal control over financial reporting and compliance with laws, regulations, contracts and grant agreements in order to determine our auditing procedures for the purpose of expressing opinions included in the audit of the CAFR and SSWAK and not to provide an opinion on internal control or on compliance.

However, during our audit we became aware of certain matters that are opportunities for strengthening internal controls and operating efficiency. The SSWAK is a separate report dated March 28, 2007, and contains all reportable conditions and material weaknesses in the Commonwealth's internal control over financial reporting and internal control over compliance and also contains all reportable instances of noncompliance. This letter does contain Department of Revenue findings and our recommendations that have been extracted from the SSWAK report along with other matters that have been identified.



To the People of Kentucky
Honorable Ernie Fletcher, Governor
John Farris, Secretary, Finance and Administration Cabinet
Department of Revenue

We will review the status of these comments during our next audit. We have already discussed many of these comments and suggestions with various Department of Revenue personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Included in this letter are the following:

- ◆ Acronym List
- ◆ Findings and Recommendations
- ◆ Summary Schedule of Prior Audit Findings

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Crit Luallen", with a long horizontal flourish extending to the right.

Crit Luallen
Auditor of Public Accounts

March 28, 2007

LIST OF ABBREVIATIONS/ACRONYMS

AFR	Annual Financial Report
CARS	Compliance And Receivable System
CAFR	Comprehensive Annual Financial Report
CD	Compact Disk
Commonwealth	Commonwealth of Kentucky
COT	Commonwealth Office of Technology
CORT	Department of Revenue's Corporate Processing Card
CTS	Comprehensive Tax System
CY	Calendar Year
DOR	Department of Revenue
eMARS	Enhanced Management Administrative Reporting System
FIFO	First-In First-Out
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GASB	Governmental Accounting Standards Board
HTTP	Hyper Text Transfer Protocol
IP	Internet Protocol
KAR	Kentucky Administrative Regulations
KERS	Kentucky Employees Retirement System
KRS	Kentucky Revised Statutes
KTRS	Kentucky Teachers Retirement System
KY	Kentucky
LAN	Local Area Network
MARS	Management Administrative Reporting System
MIXERS	Miscellaneous Taxes Registration System
OAD	Office of Application Development
OSBD	Office of the State Budget Director
REV	Department of Revenue
Revenue	Department of Revenue
SSL	Source Sockets Layer
SSWAK	Statewide Single Audit of Kentucky
UGIRLT	Utilities Gross Receipts License Tax

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 06-REV-1: The Department Of Revenue Should Work With COT To Strengthen Controls Governing Data Processing Of Taxpayer Accounts

The Department of Revenue (Revenue) did not implement an adequate process for balancing the Tax Receipt System to the Commonwealth's Management Administrative and Reporting System (MARS). Our examination revealed that the report used by Revenue to post electronic payments to the Tax Receipts System, to balance the electronic receipts with MARS, and to post receipts to taxpayer accounts through the Compliance and Receivables System (CARS), REREP108, was not developed in a manner that would allow that report to be used effectively for these processes performed by Revenue. Testing revealed that the REREP108 report does not reflect dollars refunded to taxpayers and also revealed delays between postings to MARS (creation and posting of the C1E document indicating actual receipt of funds), and the time those funds are reported on the REREP108 report.

At the time of our fieldwork in April 2006, tax receipts associated with electronic payments posted to Revenue's Tax Receipt System and MARS were irreconcilable. Testing revealed that the REREP108 report used to perform these processes did not include a data field common to the electronic payment gateway, the Tax Receipts System, and MARS that could be used to track and identify variances between the systems. Further, though the agency was aware of the variances and was working toward a solution to the problem, they were not aware that a common linked field could be used to generate a report that would identify information necessary to help properly balance the Tax Receipt System with MARS. The transactions in discrepancy were simply noted as errors and were carried forward instead of correctly identifying the reasons for the variances. These variances fluctuated throughout the year as some timing differences cleared themselves. The net variance noted for the fiscal year through March of 2006 ranged approximately from \$100,000 to \$300,000 in receipts. Further, at the time of our fieldwork in April, the agency could not specify whether these issues would also affect the posting of payments to CARS.

During our review, Revenue met with the auditor to identify a report that would include a field to allow individual transactions to be tracked from the initial electronic payment transaction through actual recording within MARS allowing a proper reconciliation between the Tax Receipt System and MARS to be performed. We acknowledge that Revenue has been working with the Commonwealth's Office of Technology (COT) to resolve issues surrounding the processing of electronic tax payments and that some progress has been made in identifying the source of the discrepancies between tax receipts processed by Revenue and the tax receipts posted in MARS. However, as of the end of FY 06, Revenue continues to use the same REREP108 report for posting to the Tax Receipts System, processing data through CARS, and to attempt to reconcile with MARS.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 06-REV-1: The Department Of Revenue Should Work With COT To
Strengthen Controls Governing Data Processing Of Taxpayer Accounts (Continued)**

The process of using the RREP108 report as a tool for posting tax payments to Revenue's Tax System and to balance with MARS is inaccurate and inefficient. This report currently does not reflect the actual posting of settled receipts as captured in MARS. Timing and other issues cause variances between this report and postings within MARS that cannot be accurately identified and explained. Further, the failure to properly investigate and reconcile variances resulting from this process illustrates a lack of due diligence and affects the integrity of data that could lead to inaccurate tax notices and penalties. At a minimum, using the RREP108 report for posting to the Tax Receipt System could result in the unnecessary expense of researching and correcting errors regarding taxpayer accounts.

The organization should establish procedures for assuring that data input is reconciled to the relevant control totals. Audit trails should be provided to facilitate tracing transaction processing and the reconciliation of data. The organization should establish proper procedures to resolve variances or errors noted using control total balancing to ensure the complete and accurate posting of transactions to the system. Transactions should be input and processed within critical systems in a timely fashion.

Recommendation

We recommend Revenue continue to work with COT to identify all sources of the discrepancies between the Tax Receipts System and MARS, to identify any effect on associated taxpayer accounts, and to make any and all corrections to taxpayer accounts if necessary. Further, we recommend that Revenue continue to pursue methods to generate a new report or to alter the current RREP108 report so that a more functional report is available for posting tax receipts to the Revenue Tax System and CARS. This report should include a data field that assists in reconciling the amounts posted from the report with those posted within MARS. Based on our examination the Merchant Order Number within the ePayment table and the transaction sequence number that is currently being used within the RREP108 report are key linking fields. A report with this additional information will aid in the reconciliation of these systems and help ensure that receipts posted within Revenue's Tax System agree with actual settled receipts posted in MARS. In addition, we recommend that Revenue work with COT to determine whether issues identified with the RREP108 report are affecting CARS posting and correct postings as needed. If needed, comparable data reports should be developed and implemented for processing through CARS to ensure the integrity of the payment data processed through that system and ultimately the tax accounts. Finally, Revenue should determine causes for delays between posting in MARS and posting within Revenue systems and ensure corrective actions are taken as necessary to alleviate any posting delays.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 06-REV-1: The Department Of Revenue Should Work With COT To
Strengthen Controls Governing Data Processing Of Taxpayer Accounts (Continued)****Management Response and Corrective Action Plan**

Revenue agrees with the auditor's findings and recommendations and will continue to work with COT to make improvements in this area. Revenue will work to have procedures documented once clear, accurate methods are developed.

**FINDING 06-REV-2: The Department Of Revenue Should Ensure Access To
Production Libraries Is Limited**

Our FY 06 audit of logical access controls for the Department of Revenue (DOR) revealed that DOR had not adequately restricted access to its production libraries. Our testing revealed 13 Commonwealth Office of Technology (COT) computer operators were provided alter access to a DOR production load library. Although, the COT computer operators are responsible for migrating programs into production from this library for DOR, they use a software application for this purpose that only requires read access to the library to perform the move. Therefore, these computer operators do not need the alter access to this load library.

A recent merging of the DOR and COT within the Finance and Administration Cabinet has resulted in many information technology employees previously located within the Revenue Cabinet relocating within COT. Because of these employee relocations, new user profiles had to be established and in the process it appears these COT computer operators were provided alter access to the load library by DOR.

Organization of the information technology functions should be structured such that the highest possible segregation of duties is achieved. Access to production load libraries should be restricted to ensure only properly authorized programs are available to be migrated into production environments. User access should be limited to the minimal access required for completion of assigned job duties. Optimally, a librarian function is established as the only user allowed to move programs into a load library to ensure proper logical access security. This prevents computer operators from having authority to introduce unauthorized programs into the library and subsequently into the production environment. If computer operators are allowed more than read access to load libraries for emergency purposes, then provision of such access levels should be temporary, the reason well documented, and their activities should be closely supervised.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 06-REV-2: The Department Of Revenue Should Ensure Access To
Production Libraries Is Limited (Continued)**

Recommendation

We recommend that the DOR security administrator work with COT to ensure the computer operator access to DOR production libraries is limited to the minimal access necessary for the operators to perform their job. Only in emergency conditions, with close supervision and documentation, should COT operators be provided greater than read access to the Revenue production libraries.

Management Response and Corrective Action Plan

While we agree any access should be granted with least privilege access in mind, changing such access cannot be performed without due process and evaluation of the potential outcome. Revenue will work with COT to review and document the current access and identify where access can be altered to alleviate this issue while continuing to allow for the COT Production area and Revenue Business requirements to succeed. This issue will be reviewed to see if we can in fact modify current permissions without adversely affecting business.

**FINDING 06-REV-3: The Department Of Revenue Should Ensure That Formal
Program Modification Control Procedures Are Developed And Implemented**

Our FY 06 audit of the Department of Revenue (DOR) program modification controls identified the absence of adequate policies and procedures governing the authorization, logging, and tracking of program change requests submitted to the Commonwealth Office of Technology (COT).

COT currently manages the change management process for DOR. Specifically, all DOR program changes are handled through submission of the COT-F001 form to the COT Office of Application Development (OAD). Once received, the form is logged and assigned for completion based upon the nature of the request. However, DOR should establish controls to ensure their requests are properly authorized, logged, and tracked to ensure timely accurate completion of requests by COT. The DOR Director is responsible for authorizing and submitting changes to COT. DOR has not established formal policies or procedures to ensure these agency level controls are met.

In addition, though DOR does not maintain a log of the COT-F001 forms submitted to COT, COT does maintain such a log. Review of this COT "change log" revealed that there were 289 DOR change requests that were indicated on the log as being open requests. Therefore it is evident that DOR has a significant number of requests that should be

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 06-REV-3: The Department Of Revenue Should Ensure That Formal Program Modification Control Procedures Are Developed And Implemented (Continued)**

monitored through implementation of adequate formal program change control procedures. Failure to establish and to consistently apply proper program modification control procedures increases the risk that incorrect or unauthorized changes to critical applications could be placed into the live production environment and adversely affect processing results for the DOR systems.

Program modification control procedures should be established and consistently applied in order to ensure that only appropriately authorized changes to critical applications are made and implemented within the production environment. Requests for all critical changes should be formally documented for proper tracking to ensure desired objectives are achieved in a timely manner. The proper authorization chain should also be documented in order to ensure that all requests are properly authorized prior to changes being migrated into a production environment.

Recommendation

We recommend that DOR establish and implement formalized program modification policies and procedures governing the authorization and monitoring process for change requests submitted to COT. The policies and procedures should include a formal process for tracking COT-F001 forms sent to COT in order to ensure that changes are completed in a timely manner.

Management Response and Corrective Action Plan

The Department of Revenue agrees with the Auditor's findings in regard to the need for the implementation of formalized program modification control procedures governing the authorization, logging, and tracking of all program change requests submitted to COT. The Department is in the process of establishing policies and procedures in regard to authorization, logging, and tracking of all program change request submitted to COT. Controls will be established to ensure that all requests are properly authorized and tracked to ensure that desired objectives are achieved timely and accurately. One employee within the Commissioner's Office will be responsible for maintaining a log of all COT-F001's requested by DOR, verifying that all requests are properly authorized, tracking the status of request and participating in all meetings between COT and DOR concerning any change request.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 06-REV-4: The Department Of Revenue Should Implement Procedures To Protect Cigarette Tax Stamps

The Department of Revenue (DOR) has failed to establish adequate internal controls over tax stamps. DOR received \$165,310,066 for the cigarette excise tax and surtax during FY 06; this was 1.9% of General Fund receipts. Existing controls take into account neither the importance of the tax revenue nor the vulnerability of the stamps to theft: both physical security over the stamps and the system of records need improvement, and segregation of duties should be implemented.

DOR staff members accidentally mailed six rolls of 30,000 stamps to the wrong address, but only five of the rolls were returned. The missing roll had a tax value of \$9,000.

Three DOR field offices sell cigarette tax stamps. The most popular format is rolls of 30,000 stamps that are delivered in boxes of 25 rolls. All locations are supposed to sell stamps on the first-in-first-out principle. However, one field office empties one box before going on to the next, the order in which it uses the boxes appears random. This complicates tracking the stamps by serial number.

Cigarette tax stamps are portable due to their small size, and they might be sold if stolen. Consequently, DOR should maintain stringent internal controls over them. The need for good controls appears to have been overlooked because the amount of money collected when the tax of \$0.03 per pack was comparatively small; however, the surtax imposed by the legislature beginning June 1, 2005 increased the cigarette tax rate tenfold. Despite the magnitude of the tax revenue, the DOR maintains inadequate records vulnerable to changes that leave no audit trail, stores the stamps in a location where dozens of people have access to them, and fails to employ segregation of duties.

DOR has also failed to maintain sufficiently tight security over the vault where the stamps are stored. Because virtually all employees know the vault key is kept in a desk drawer in the mailroom, we must assume that everyone in the office has access to the vault and to the cigarette stamps stored in it. The largest stamp format is a roll of 30,000 in a box measuring approximately 2" x 2" x 12". A box of these stamps with a tax value of \$9,000 could be readily concealed and carried outside the vault. The vault camera provides virtually no protection for the stamps because it covers only the vault door, not the vault's interior.

The records maintained on cigarette tax stamps are deficient in three respects. First, they are kept in a spreadsheet program. Entries and changes require no approvals, and no electronic or paper log of them is generated. Next, no records focus on accounting for each individual sheet or roll of stamps. Tracking each serial number helps assure that no stamps have been mislaid or misappropriated. Finally, no reconciliation of stamp sales to tax revenue takes place.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 06-REV-4: The Department Of Revenue Should Implement Procedures To Protect Cigarette Tax Stamps (Continued)

DOR has failed to implement appropriate segregation of duties. A single individual has been assigned responsibility for approving sales to cigarette wholesalers, taking stamps from the vault to package shipments, and keeping records of the sales and stamp serial numbers. This employee also assists in the physical inventory count of the stamps and performs a reconciliation of the count to the records. Assigning all those responsibilities to the same individual makes it possible to carry out a theft and conceal it by altering the records.

The incident of the misdirected stamps prompted an internal review of the procedures to obtain, secure, sell, and account for cigarette tax stamps. The review report performed by the Assistant Director in the Special Investigations Division dated March 9, 2006 contained recommendations to improve these procedures. All but two of those appear in the recommendations below; the exceptions are the establishment of a second log (the apparent purpose of this is tracking individual sheets and rolls of stamps, which is covered in recommendation 3) and expanding the spreadsheet to include wholesaler names and license numbers (this appears to be unnecessary duplication of records maintained). To date the DOR has put into place only the proposal to conduct a monthly physical count of the stamps. As implemented, however, the new procedure fails to employ the recommended segregation of duties. One of the people assigned to conduct the inventory is the employee who has primary responsibility for cigarette tax stamps, not (as recommended) someone independent of the cigarette tax stamp process. This employee also reconciles the physical count to the recorded sales.

The cause of the out-of-order sales of stamps at one field office is failure to exercise care in the storing and use of the boxes of stamps.

The reported value of cigarette stamps stored in the vault was \$137,135,980 on June 30, 2005 and \$97,939,541 on June 30, 2006. This is the amount of revenue at risk if the stamps were to be stolen and subsequently used by unscrupulous dealers.

Good internal controls protect more than assets; they also protect the reputations of the employees who handle those assets. Failure to implement segregation of duties means that the employee who handles the stamps would automatically fall under suspicion if stamps were ever mislaid or stolen.

Segregation of duties prevents theft except in cases of collusion. While very small organizations may find it necessary to implement compensating controls because there are too few people to implement this key control, DOR is large enough to apply segregation of duties in all key areas. The functions of custody (physical access to the stamps, taking the inventory count), authorization (approval of orders), and record keeping (recording sales, reconciling inventory) should rest with different individuals or departments. At present a single individual performs all these duties.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 06-REV-4: The Department Of Revenue Should Implement Procedures
To Protect Cigarette Tax Stamps (Continued)**

DOR has a fiduciary duty to protect the state's liquid assets. Cigarette tax stamps are a liquid asset, easily concealed and readily marketed, so they should be stored in a secure environment. Maintaining reliable records is another essential safeguard.

Recommendation

We recommend that the Department of Revenue adopt the following procedures:

1. Assign responsibility for the monthly physical inventory count and reconciliation to two individuals whose other duties do not involve cigarette tax stamps.
2. Strengthen vault security. (This is addressed in greater detail in a separate finding.)
3. Request that COT establish a database for cigarette tax stamp records. This should feature appropriate controls and create a report that tracks each sheet or roll from the time of receipt to shipment to field office (if applicable) to shipment to a wholesaler.
4. Implement internal audit procedures to cover cigarette tax stamps that include reviews of the inventory stored in all four locations.
5. Enforce consecutive sales of cigarette tax stamps at all field offices. Ordinary care in stacking new deliveries and selecting the next box to open is all that would be needed to implement this.

Recommendations one through four are based on those found in the report mentioned above dated March 9, 2006 from the Assistant Director in the Special Investigations Division.

Management Response and Corrective Action Plan

On the recommendation of the assessment done by the Department's Special Investigations Division and the Auditor of Public Accounts, procedures are being developed and put in place to ensure the security of the cigarette stamps at the Perimeter Park location and at the Taxpayer Service Centers that hold an inventory of cigarette stamps. This will include segregation of duties. Procedures have been implemented at the Taxpayer Service Centers to ensure FIFO sale of stamps. Research is being conducted on the recommendation to have COT develop a database for cigarette stamp inventory control.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 06-REV-4: The Department Of Revenue Should Implement Procedures
To Protect Cigarette Tax Stamps (Continued)**

Auditor Reply

In addition to the incident reported above, the Department of Revenue received notice on September 28, 2006 that two rolls of cigarette tax stamps, each with 30,000 stamps, were missing from a shipment made via a commercial carrier. The Director of the Division of Special Investigations conducted an investigation, and the report dated October 9, 2006 concluded that the probable cause was damage to the box used to ship the order. While it appears that theft did not occur, this subsequent event highlights the stamps' vulnerability to loss or theft and the importance of implementing a strong system of controls. Based on this additional information, we also recommend that DOR use sturdier packaging and review shipping methods to further reduce the risk of intentional or unintentional damage or loss.

**FINDING 06-REV-5: The Department Of Revenue And Office Of State Budget
Director Should Ensure That Tax Receipts Belonging to County Governments Are
Properly Accounted For In the Fiduciary Fund At Year End**

The Department of Revenue (DOR) collects several types of property taxes; some of these taxes include both a state portion and a local government portion. Both the state and local share are deposited into the General Fund. Periodically DOR distributes the local government share after first transferring it to the Special Deposit Trust Fund using journal vouchers. Local governments receive the fiscal year's last payment in August of the next fiscal year. Previous audits noted inconsistency in the timing of the year's last journal voucher transfers from the General Fund to the Special Deposit Trust Fund. The transfer occurred before June 30 in 2000, 2001, 2004, 2005, and 2006, but after June 30 in 1997, 1998, 1999, 2002, and 2003.

Prior audit findings addressed the importance of consistency in financial reporting. A closer examination of this issue indicates that revenue recognition is a problem here. The local property taxes collected by the state are fiduciary funds owed to another entity, not state funds. By leaving them in the General Fund for several weeks or months after collection, General Fund receipts and fund balance are overstated until the transfer to the Special Deposit Trust Fund takes place. When the transfer takes place after a new fiscal year has begun, the General Fund has improperly recognized revenue.

The MIXERS tax system is not set up to credit the local government share of property taxes to the Special Deposit Trust Fund upon receipt. Revenue from four tax types [General Property Tax-Real (R251), General Property Tax-Tangible (R252), Public Service Companies Tax (R260), and Apportioned Vehicle Property Tax (R266)] is instead

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
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Director Should Ensure That Tax Receipts Belonging to County Governments Are
Properly Accounted For In the Fiduciary Fund At Year End (Continued)**

credited to the General Fund upon receipt. Multiple journal vouchers transfer a share of the tax revenue from the General Fund to the Special Deposit Trust Fund as tax type General Property Tax-Tangible Motor (R253). The tax revenue recorded in the Special Deposit Trust Fund is then distributed to local governments. Similarly, a transfer takes place for tax type Omitted Tangible Property Tax (R265) from the General Fund to the Special Deposit Trust Fund, although the tax type did not change.

A FY 04 comment (04-REV-6) noted the inconsistency between the property tax transfer timing in fiscal years 2003 and 2004 and recommended adoption of a consistent policy. In its response DOR agreed to work with the Office of the State Budget Director (OSBD) to establish a policy on transfer timing. OSBD issued a letter dated May 25, 2005 establishing a policy that in essence means the handling of journal vouchers will be guided by the fiscal condition of the Commonwealth on June 30 of each year. This policy fails to address the auditor's concern with accurate and consistent financial statement presentation. Consequently, a repeat finding (05-REV-7) emphasized the importance of consistency to GAAP compliance. The management response to the second finding consisted of the portion of the May 25, 2005 letter that discussed the policy's rationale.

Because MIXERS does not credit the local government share of property taxes to the Special Deposit Trust Fund upon receipt, these fiduciary funds are mingled with governmental funds (the General Fund).

Whenever the transfer is made after June 30, General Fund receipts and fund balance are overstated. Fiduciary assets and liabilities for the Special Deposit Trust Fund are understated if the transfer occurs after June 30.

In response to the FY 04 finding DOR and the (OSBD) adopted a policy to vary the timing of the transfers according to year-end budgetary considerations; in other words, to include money that is the property of local governments in General Fund receipts in order to show a balanced budget or trigger surplus spending. This is improper revenue recognition and a violation of Generally Accepted Accounting Principles (GAAP). Adopting a policy that allows this encourages management to manipulate financial reporting.

As written, the policy adopted by the Office of the State Budget Director could result in inaccurate and inconsistent financial reporting. Depending on the timing of the transfer in any given year, the General Fund and Special Deposit Trust Fund could be overstated or understated by the amount of the fourth quarter transfer. This would result in inconsistent financial presentation for analysis and policy purposes, and could also result in a misstatement in the financial statements for both funds.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 06-REV-5: The Department Of Revenue And Office Of State Budget Director Should Ensure That Tax Receipts Belonging to County Governments Are Properly Accounted For In the Fiduciary Fund At Year End (Continued)

GAAP requires each fund to recognize revenue in the appropriate accounting period and fund. Section 7.344 of the GASB Comprehensive Implementation Guide says the following when it addresses the issue of a government's use of one of its funds as a clearing account for property taxes:

Q—A county tax collector collects property taxes for all taxing bodies in the county, including the tax-levying funds of the county. The county uses an agency fund as a distribution mechanism for the taxes. At year-end, the collector is holding \$3,450,000 in the tax distribution account. Of that total, \$750,000 will be distributed to the county funds, and the remaining \$2,700,000 represents taxes collected for the other taxing bodies in the county. How does the county apply the “clearing account” provision in paragraph 111 of Statement 34 for agency funds for agency funds?

A—In the county's financial statements, the tax collector's agency fund would report only the \$2,700,000 in cash with an equal amount as a liability to other taxing bodies. The \$750,000 collected and on hand for the county's funds would be reported as cash (rather than taxes receivable or due from agency funds) in the appropriate funds. In essence, the collector has a “pooled” cash account, similar to an internal investment pool. The allocation of cash balances to the county funds is consistent with the requirement in paragraph 14 of Statement 31 that requires the “equity position” of each fund in an internal investment pool to be reported as assets in those funds.

The GASB Statement 31 requirement on reporting the equity position of each fund means that the local government property tax share should never be reported within the General Fund. Therefore, the transfer of these amounts to the Special Deposit Trust Fund should take place before the fiscal year ends.

The present policy established by DOR and the OSBD anticipates inflating General Fund revenues by delaying the property tax transfers, thus creating the appearance of budgetary compliance when it does not exist. This violates GAAP, as explained in the preceding paragraph.

We recognize that the Finance and Administration Cabinet and the Office of the State Budget Director have specific statutory duties to properly manage the financial affairs of the Commonwealth, including compliance with budgetary requirements. Controlling expenditures, making realistic revenue estimates, and monitoring activity throughout the year are the proper ways to discharge that duty. Manipulating financial reporting is not a legitimate method of budgetary control. Even though the transfers were appropriately recorded during FY 06, the policy permits inconsistent treatment because the timing will vary with changes in budgetary needs. Financial statements should be prepared in a manner that provides accurate, comparable data for its users.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
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Director Should Ensure That Tax Receipts Belonging to County Governments Are
Properly Accounted For In the Fiduciary Fund At Year End (Continued)**

Recommendation

We recommend that DOR modify its MIXERS system to transfer the local government share of property taxes to the Special Deposit Trust Fund upon receipt. It should also incorporate this feature into the Comprehensive Tax System now under development.

Until Revenue's systems are able to do this, we recommend that DOR transfer the local share of property taxes to the Special Deposit Trust Fund no later than June 30 of each fiscal year.

Management Response and Corrective Action Plan

If the situation arises where the Department of Revenue is directed to initiate journal voucher transfers after June 30, it will ensure that Form AFR 35 is completed as part of the closing package, which will account for the transfer as part of the CAFR procedures; as a result the financial statements will not be misstated. The modification of the MIXERS system as recommended by the Auditor would be a very expensive endeavor and is not feasible at the present time. The recommendation made by the Auditor to incorporate the transfer of local government property tax funds upon receipt to a Special Deposit Trust Fund in the Comprehensive Tax System will be reviewed for consideration by the Department.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 06-REV-6: The Department Of Revenue Should Improve Physical Security Measures

Our audit of the physical access controls for the Department of Revenue (DOR) during FY 06 revealed that physical security controls should be improved at the Revenue Fair Oaks and Perimeter Park locations. Two weaknesses were specifically noted.

First, the Kentucky Community Preparedness Program, which is part of the Department of Criminal Justice Training, conducted a vulnerability assessment of the Fair Oaks and Perimeter Park facilities. They issued numerous recommendations to DOR to improve physical security at both of these locations. While most of these recommendations have been adopted, there are a few that have not been adequately addressed. Recommendations not addressed include the following:

- Installation of physical barriers within the DOR parking lots,
- Upgrading to shatter resistant exterior glass (Perimeter Park only),
- Installation of parking lot cameras, and
- Installation of back-up generators.

The second control issue concerned the poor environmental conditions within the Division of Operations switch room at the Revenue Perimeter Park location. The switch room or closet houses unused equipment and wiring, in addition to the main routers. During our audit, we noted extreme heat buildup within the area as well as dust problems that required that the door be left unlocked and open. This situation increases the security risk of unauthorized access to that room as well as the likelihood of system failure due to the poor conditions.

Without proper precautions taken to ensure the protection of DOR's physical property, the possibility exists of unauthorized entry, theft or damage to property, financial loss, legal repercussions, or loss of credibility.

Good physical security controls reduce the risk of malicious or accidental destruction or the unauthorized use of hardware, files, programs, documentation, and source documents. Formal physical security policies provide a security framework to educate management and users of their security responsibilities. Consistent application of formalized security policies and procedures provides continuity for implementation and sets the tone of management concern for strong physical security.

Recommendation

We recommend the Department of Revenue continue its efforts to implement the physical security controls as recommended in the physical security assessments conducted by the KY Community Preparedness Program. Furthermore, the DOR Division of Operations should ensure the switch room (closet) at Perimeter Park is environmentally controlled and properly secured. Temperature and humidity, dust and contaminants, backup power supplies, cable maintenance, and access security should all be considered and adequately controlled for effective reliability and longevity of equipment.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 06-REV-6: The Department Of Revenue Should Improve Physical Security Measures (Continued)

Management Response and Corrective Action Plan

The Department of Revenue agrees with the Auditor's finding and the recommendations and will consider them as planning continues relating to a change in location which may occur within the next two years. In regards to the second issue, the DOR agrees with the Auditor's findings in regard to the switch room located at Perimeter Park. The switch room is maintained by COT and COT will be notified of the Auditor's findings.

FINDING 06-REV-7: The Department Of Revenue Should Ensure That All Open Ports On Agency Machines Have A Business-Related Purpose And Do Not Disclose Excessive Information

While performing the security vulnerability assessments for FY 06 for machines controlled by the Department of Revenue (Revenue), our examination identified four out of 13 machines, or 30.8 percent of the population, with open ports that disclose excessive information to an anonymous user. These findings are grouped below by port number.

Port 80 – HTTP

Four machines were found to have port 80 open. All four of these machines were identified during the FY 05 audit. The agency response to the FY 05 comment indicated that these machines are secured; however, an anonymous user can still view excessive information without authentication.

Port 443 – Hypertext Transfer Protocol over Secure Socket Layer (HTTPS/SSL)

One machine was found with port 443 open. This machine provided the ability to view and change configuration settings without authentication and had an expired SSL security certificate. The same website was displayed on both port 80 and port 443 for this machine.

The existence of unused open ports increases potential security vulnerabilities and is an invitation for intruders to enter the system. System configuration information would be intriguing to a hacker and should be restricted.

To minimize the risk of unauthorized access to a machine, only necessary, business-related ports should be open. Information concerning system configuration should not be made publicly available. Unauthorized users should not have the ability to view or make system configuration changes. Excessive network information should not be disclosed to anonymous users.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 06-REV-7: The Department Of Revenue Should Ensure That All Open Ports On Agency Machines Have A Business-Related Purpose And Do Not Disclose Excessive Information (Continued)

Recommendation

We recommend that Revenue review all open ports to ensure there is a specific business-related purpose requiring the port to be open. If not required, then that port should be closed. If the port is necessary then Revenue should ensure the most recent patches are implemented for the service in use and that adequate logical security controls are implemented to prevent unauthorized access as necessary. We also recommend that Revenue further restrict the level of information provided to anonymous users through web browsers on the identified machines.

Management Response and Corrective Action Plan

The four IP Addresses in question are for various printers and use HTTP/HTTPS for web-enabled management of the printer. These addresses will be given to the LAN/Network administrators to see if it is possible to further protect them from information leakage. However in some instances printers of this nature are known to have limited capabilities to prevent some degree of information leakage. They are however using private IP addresses that are not publicly available outside of the state network.

FINDING 06-REV-8: The Department Of Revenue Should Implement Additional Vault Security Measures

The Department of Revenue (DOR) has implemented several improvements to physical security arrangements at the Perimeter Park facility in response to FY 05 audit finding (05-REV3-30), but some weaknesses remain. Corporate and income tax returns that may still have checks attached are stored overnight in office space, but responsibility for locking the office is not clearly defined. Also, the absence of security camera coverage inside the vault and vault key storage location remains a concern.

DOR lacks written procedures governing vault access and usage.

In order to reduce the number of people who need daily access to the vault, DOR changed the storage site for tax returns awaiting batch verification from the vault to office space. At the workday's end employees roll carts holding these returns into an office. The last employee to leave is supposed to lock the office, and the first to arrive in the morning to unlock it, suggesting that anyone with access to the area has access to the key.

A security system camera is pointed at the door to the Perimeter Park vault, but it fails to record activity within the vault. Neither the vault key location nor the room used to store returns overnight is covered by a security camera.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 06-REV-8: The Department Of Revenue Should Implement Additional Vault Security Measures (Continued)**

The Perimeter Park vault holds cigarette tax stamps, a liquid and portable asset. The tax value of the stamps stored in the Perimeter Park vault on June 30, 2006 was \$97,939,541.25. Without proper monitoring, this is the amount of tax revenue placed at risk due to loss or theft.

Failure to assign responsibility for locking up increases the risk that the task will be overlooked. If that were to happen, the level of protection for checks waiting processing would be significantly reduced. The checks also remain vulnerable to damage from fire and other hazards while stored in an office. Furthermore, increasing the number of people with access to the safeguarded returns weakens the security over them.

Good internal controls dictate that proper precautions be taken to safeguard assets from loss, damage, or misappropriation. Strong internal controls are essential to protect the department's assets.

Recommendation

The Department of Revenue should:

- Assign responsibility for locking up the returns awaiting batch verification to a specific employee. One or two alternates should be selected to perform this duty in the absence of the primary employee. DOR should also explore the feasibility of installing a fireproof system in the storage area.
- Arrange for security camera coverage within its vault at Perimeter Park. This could be accomplished either by installing a camera within the vault or moving the camera that now points at the door to a location that aims at both the door and interior. In its response to the FY 05 finding, DOR declined to act on this issue due to concerns about the vault's structural integrity. However, a power supply already exists in the vault for the overhead lights, and using that source to power a camera and using the same conduit to connect the camera to the existing security system appears feasible.
- Arrange for security camera coverage of the vault key storage.
- Establish written vault procedures. These should address the following topics:
 - Items that should and should not be stored in the vault
 - A list of people or positions who are allowed vault access
 - A requirement forbidding anyone from entering the vault alone
 - Creating a vault access log

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 06-REV-8: The Department Of Revenue Should Implement Additional Vault Security Measures (Continued)**

Recommendation

In addition to the recommendations above, DOR should prepare for changes to vault procedures as a result of its planned move to another site during 2007. Addressing accessibility is especially critical since the entire Department will be within the same building as the vault, not just the Division of Operations as is the case now.

Management Response and Corrective Action Plan

The Department of Revenue agrees with the Auditor's recommendation. Responsibility of unlocking and locking of the space used to store returns that are waiting to be processed has been assigned to the branch manager and two designees. The vault key is secured in a lock box and has been placed within the view of the security camera along with the vault access log. Written procedures identifying items to be stored in the vault, identifying individuals with access to the vault, requiring that no one shall enter vault alone and requiring the signing of the vault access log have been developed and implemented. Due to the relocation of the Division of Operations to the State Office Building within the near future, DOR is not likely to pursue the installation of a security camera in the vault located at Perimeter Park.

FINDING 06-REV-9: The Department Of Revenue Should Eliminate Backlog For Processing Of Corporate Tax Returns

The Department of Revenue (DOR) did not complete the data entry or "coding" process of corporate tax returns for tax years ending December 31, 2005 until November 2006 due to a delay in completing the new corporate data entry system.

As a result, corporate refund processing was suspended for several months. The auditor also was unable to examine three of 25 returns selected for testing because several boxes of returns shipped to the vendor for processing remain there pending implementation of the data entry system.

Entry of corporate transaction data including payments from the CORT cards is also significantly delayed, but compliance efforts have not taken this into account. As a result, one taxpayer in the sample was issued a bill for corporate tax when a payment had accompanied its extension request and return. The amount overpaid by the taxpayer was \$750.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 06-REV-9: The Department Of Revenue Should Eliminate Backlog For Processing Of Corporate Tax Returns (Continued)**

DOR corporate tax section staff formerly entered all corporate return data. To prepare for the major changes to corporate returns resulting from tax modernization, DOR contracted with a private company (SourceCorp) to perform all corporate return data entry beginning January 1, 2006. Accordingly, DOR did not develop the capacity to enter corporate return data in-house for returns covering years ending December 31, 2005 or later. DOR continues to enter payment data for returns, extension requests, and estimated payments. The joint project to design and implement a system to capture corporate return data has proved more difficult and time-consuming than expected. Corporate data entry for tax years ending December 31, 2005 or later did not begin until mid-November 2006. Around 108,000 corporate returns (including estimated tax payments, requests for extensions, and year-end returns from C-corporations, S-corporations, and pass-through entities) awaited data entry at the end of September 2006. Approximately 18,000 C-corporation returns had been shipped to SourceCorp and were not available to the auditor.

The provisions of tax modernization have created a nearly 50% increase in corporate filings, while no additional staff has been hired for the Corporate Processing Section. A backlog has developed because of the workload's size. However, it appears that corporate tax bills have been issued before payments have been recorded in DOR's system.

Some corporate returns feature a net operating loss carryforward or credit for excess tax paid in an earlier period. Consequently, one aspect of assessing compliance is verification of data from the prior year's return. DOR's initial shipments of corporate returns to SourceCorp were prior year returns for that reason. Data entry from those returns has just begun. Approximately 18,000 C-corporation returns shipped to SourceCorp remained there as of November 15, 2006. Those returns have been inaccessible for months, while approximately 19,000 other C-corporation returns await shipment to SourceCorp from Revenue Operations. Three out of twenty-five randomly selected corporate returns had been shipped to SourceCorp and were not available for the auditor to examine. Also, three other returns contained four tax preparer errors that ought to cause a review after data entry. No action had been taken on those returns.

Work on refunds related to pass-through entities did not begin until October 2006. As of mid-November, approximately 900 of 1,300 refund requests had been processed.

Corporate tax compliance efforts begin with worklists generated from exceptions to established criteria. Until mid-November 2006, every 2005 corporate return awaited data entry. No bills have been issued for any incorrect tax calculations. Only taxpayers who have complained were issued refunds prior to October 2006. Deferring the payment of refunds may offset the negative cash flow impact of the delay in billing underpayments; however, both interest payable on refunds and interest foregone on underpayments represent a loss to the Commonwealth of Kentucky. Further, delayed compliance work increases the risk that a corporation will cease doing business or go bankrupt before action on unpaid corporate tax can be taken.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 06-REV-9: The Department Of Revenue Should Eliminate Backlog For Processing Of Corporate Tax Returns (Continued)

When information such as the receipt of returns, extensions, or payments is not recorded timely, DOR employees do not have adequate information to accurately determine accounts receivable or answer taxpayer questions. As shown above this can cause bills to be issued when no liability exists. The auditor's test found one instance of this, and other cases also may have occurred.

Promptness is essential to assuring the most complete taxpayer compliance possible.

As stated in KRS 141.210 (2):

As soon as practicable after each return is received, the department shall examine and audit it. If the amount of tax computed by the department is greater than the amount returned by the taxpayer, the additional tax shall be assessed and a notice of assessment mailed to the taxpayer by the department within four (4) years from the date the return was filed, except as otherwise provided in this subsection.

The DOR has a fiduciary duty to make every reasonable effort to maximize interest income and minimize interest expense.

Kentucky's Taxpayer Bill of Rights states in part: "As a Kentucky taxpayer, you have the right to expect the Department of Revenue to honor its mission and uphold your rights every time you contact or are contacted by the Department of Revenue." The Department of Revenue's mission statement reads: "The mission of the Kentucky Department of Revenue is to administer tax laws, collect revenue, and provide services in a fair, courteous, and efficient manner for the benefit of the Commonwealth and its citizens." The 2005 corporate returns have sat for half a year before completing the data entry or "coding" process. This is not efficient, and for taxpayers who have requested a refund, it is arguably unfair.

Recommendation

The DOR should:

- Take measures to immediately eliminate the backlog in corporate data entry.
- Establish realistic timelines and plan to assure uninterrupted compliance efforts and refund processing when changes occur in the future, including the cutover to the new Comprehensive Tax System.
- Place a moratorium on the mailing of corporate tax bills until payment data has been entered for all timely filings for that year.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 06-REV-9: The Department Of Revenue Should Eliminate Backlog for Processing of Corporate Tax Returns (Continued)**

Management Response and Corrective Action Plan

The Department of Revenue agrees with the Auditor's findings. Our response is as follows:

Additional Office of Income Taxation resources were assigned to the backlog of 1300 refund requests described and those refund requests have been worked. A few such requests are still pending due to incomplete information submitted by the taxpayer.

The statement made that "no bills have been issued for any incorrect tax calculations" no longer applies. The DOR agrees that this was a true statement but with one of the over 80 error codes built into the corporate coding system over 500 assessments for incorrect computations of the alternative minimum calculation have been generated. Credit forwards and net operating loss carryforwards from prior periods are verified when compliance work is performed on a 2005 return.

Recommendation 1 - Take measures to immediately eliminate the backlog in corporate data entry. ***DOR Response:*** We agree with this recommendation. The backlog for entering 2005 corporation income tax returns into the corporate coding system has been greatly reduced.

Recommendation 2 - Establish realistic timelines and plan to assure uninterrupted compliance efforts and refund processing when changes occur in the future, including the cutover to the new Comprehensive Tax System. ***DOR*** – We agree with the recommendation. We have learned many lessons in administering the most comprehensive tax law changes in the history of the Commonwealth. In the future, we will devote additional resources from existing staff to assist in the processing of returns including during the cutover to the new Comprehensive Tax System.

Recommendation 3 - Place a moratorium on the mailing of corporate tax bills until payment data has been entered for all timely filings for that year. ***DOR*** – We agree with the auditor's findings that one incorrect bill was issued. This was an extremely isolated occurrence in the Division of Collections involving an inexperienced employee. As a result, additional training is being provided to appropriate staff.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 06-REV-10: The Department Of Revenue Should Ensure That The Commonwealth Of Kentucky's Withholding Account Is Reconciled With W-2 Filing**

The amount remitted to the Department of Revenue (DOR) for state withholding during CY 05 does not agree to the total amount withheld in the annual report of employee W2 forms filed with the Commonwealth of Kentucky. In addition, DOR made errors posting withholding payments that had not been corrected as of December 2006.

More than one-third (36.3% or \$2,924,597,241.72) of general fund receipts during FY 06 came from employer payments of state individual income tax withheld from employee paychecks. After the end of the calendar year employers prepare a filing that lists the name, social security number, state and federal wages, and all withholding amounts of every employee. As part of a test of withholding, the auditor compared information from 34 W2's to the employer's filing; the auditor also checked for appropriate action if the employer's total withholding amount exceeded payments made.

The employer in one sample item was the Commonwealth of Kentucky, which reported withholding \$72,654,857.05 in CY05. Payments credited to Revenue's system for CY05 totaled \$71,949,335.63, resulting in a shortage of \$720,440.59. When adjusted for the errors described below, the payment record should have shown a total of \$72,883,825.50; this payment amount breaks down into \$72,099,613.29 for the state's P1 payroll and \$784,212.21 for other state systems (KERS, KTRS, State Fair Board Imprest Cash Payroll, and Master Commissioners). The amount of withholding reported is thus \$555,243.76 more than payments for the state's P1 payroll and \$228,968.45 less than the combined payments. No follow-up to reconcile the state's withholding account is performed.

The Department of Treasury combines withholding from the state P1 payroll and withholding from other state systems (KERS, KTRS, State Fair Board Imprest Cash Payroll, and Master Commissioners) before transferring the tax to DOR. DOR employees use data e-mailed from Treasury to prepare a "dummy" return that credits the combined transfer of tax receipts to a single account within the withholding database.

A discrepancy between the MARS record and Revenue's withholding database occurred during the second January 2005 pay period. MARS shows a transfer of \$3,053,891.71 from the combined payroll. However, the e-mail to DOR from Treasury giving transfer instructions said \$3,019,401.84, the amount of withholding from the state P1 payroll only. DOR's payment record is incorrect as a result of this \$34,489.87 error.

The state withholding transfer for the second December 2005 pay period does not match Revenue's payment record. The transaction is on record in MARS for \$3,052,746.82, but Revenue's payment shows \$2,152,746.82 (\$900,000 less). Examination of the complete transaction showed that payment was made for the proper total, but it was divided to credit two different periods; \$900,000 was entered in January 2006 for the month of December 2006, not December 2005. This indicates a system weakness, because withholding payments should not be credited to future accounting periods.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 06-REV-10: The Department Of Revenue Should Ensure That The Commonwealth Of Kentucky's Withholding Account Is Reconciled With W-2 Filing (Continued)**

Though their records indicated an underpayment of withholding taxes for the Commonwealth's account, DOR's Withholding Compliance Section of the Individual Income Tax Division had not followed-up on the discrepancy prior to inquiries from the auditor's office.

103 KAR 18:010 Section 1 states, "Every employer incorporated in Kentucky, qualified to do business in Kentucky, doing business in Kentucky, or subject to the jurisdiction of Kentucky in any manner, and making payment of wages subject to withholding shall deduct, withhold, and pay to the cabinet the tax required to be withheld." The Commonwealth should fulfill the requirements of this regulation itself.

When the amount of withheld tax transferred does not match the amount withheld, and no attempt is made to reconcile the account, the state cannot be assured that the employer is in compliance.

Employer withholding was the single largest revenue source for Kentucky's General Fund in FY 06. Accurate receipt records are essential to the reliability of the state's forecasts and budgets.

Recommendation

DOR should reconcile the Commonwealth's withholding account each year.

DOR should work with Treasury to implement improved procedures that ensure complete and accurate tax payments and annual filings.

- One option would be for DOR to establish separate withholding accounts for each of the other state agencies. Treasury then would make separate payments and annual filings for state employees and each agency. This would produce clear records and simplify the reconciliation process, though at the cost of additional bookkeeping.
- If DOR and Treasury prefer to continue using a single withholding account, procedures should be established to assure that all the other state systems are represented in the annual filing.

The annual employee W2 report should be reconciled to the payment record before it is filed with DOR.

DOR should also investigate the extent to which its system will accept payments made in advance of the applicable tax period and consider whether to modify the system to prevent such payments. Corrections should be made to properly record all CY 05 payments.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 06-REV-10: The Department Of Revenue Should Ensure That The Commonwealth of Kentucky's Withholding Account is Reconciled With W-2 Filing (Continued)

Management Response and Corrective Action Plan

In reviewing the document from the State Auditor, there were concerns about the reconciling of the Commonwealth of Kentucky's 2005 withholding account. It was determined that the payments to the withholding account included withholdings for Kentucky Retirement Systems, the Teacher's Retirement System, various Master Commissioners around the state and the State Fair Board's imprest cash payroll. It is our understanding that none of these items are in the payroll system or are reflected on the W-2s that we receive. For this reason, the department could not reconcile the payments to the W-2s, which is the general practice in reconciling withholding accounts. DOR will have further discussions with Treasury to determine the best possible solution in order to reconcile the account in the future. The Auditor's Office has suggested two options and we will explore with Treasury to determine the best alternative for all parties.

Two discrepancies were reported in the Auditor's report. One concern was the amount of \$34,489.87 that was not applied to the 1/05 period. The journal voucher to correct this discrepancy was completed on 2/23/07. The email that was received from Treasury stated that the transaction was for \$3,019,401.84 when in reality it was \$3,053,891.71. This was discovered by Revenue's checks and balances in May 05. At that time, the error was corrected in the receipt account, but a correction to the tax account did not occur. Refresher training has been given to the employees involved.

Another concern was a payment of \$900,000 that was misapplied to the 12/06 period when it should have been applied to the 12/05 period. In our research of this payment, there was a transmittal problem that caused this error. Due to the fact that these journal voucher payments have to be done manually, it is our belief that human error caused this transaction to be misapplied. The money should have been posted to the 12/05 period and not the 12/06 period. The journal voucher to correct this error was completed on 2/15/07. Again, refresher training has been given to the appropriate staff.

A concern was also raised as to how the payment could be posted to a future period. It was the Auditors recommendation that a modification be made to the system to prevent such postings. Presently, DOR is in the process of developing a new Comprehensive Tax System (CTS) that may address such issues when implemented. Due to this system currently being developed, it is not economically feasible to make changes to the current system at this time.

We wish this response to note that if a regular reconciliation is achieved, no increase to General Fund receipts will occur. The Department of Revenue most likely will have to divert resources from revenue-producing initiatives to help effect an accurate reconciliation of the Commonwealth's withholding account.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 06-REV-11: The Department Of Revenue Should Ensure That Administrative Fees Are Accurately Accounted For In The State's Accounting System

Administration fees for Utilities Gross Receipts License tax (UGRLT) are not being accurately entered in the state's accounting system. As provided by KRS 160.6154, the Department of Revenue (DOR) retains 1% of amounts distributed to school districts to cover the cost of administration. Ordinarily the transfer to the fee account (R464) occurs at the same time as the distribution. However, no transfer was made in connection with the distributions on October 31, 2005 and June 30, 2006, while two transfers took place in connection with the January 31, 2006 distribution. DOR made 15 distributions of UGRLT during FY 06, so the error rate for the fee transfer is 20%.

DOR began to collect and distribute UGRLT at the start of FY 06, so related procedures are new. It appears that management does not compare reported fee amounts to data in the statewide accounting system.

DOR failed to record in MARS the October 31, 2005 fee of \$139,432.34 and the June 30, 2006 fee of \$109,300.24. It recorded the January 31, 2006 fee of \$170,440.63 twice. The net impact is that UGRLT administration fees were understated in MARS by \$78,291.95.

Good internal controls dictate that the accounting system should capture all transactions in their entirety and that management should monitor receipt accounts for accuracy.

Recommendation

The Department of Revenue should amend its recording and monitoring procedures to assure that the fees actually retained are entered in the state's accounting system.

Management Response and Corrective Action Plan

The Department of Revenue (DOR) agrees with the Auditor's findings and will implement changes to follow the Auditor's recommendations. DOR will seek system changes with the support of the Commonwealth Office of Technology (COT) to further automate the creation of simultaneous checkwriter files, and DOR employees in the Division of Miscellaneous Taxes will take over the eMARS upload distribution (which includes the 1% administration fee). This change will eliminate the need for manual journal vouchers by DOR Operations staff after the initial monthly distribution to school districts. This procedure is currently in place for TELECOM and appears to be working well. The implementation of this change is contingent upon the availability of COT resources. It will also require training of pertinent staff in the Division of Miscellaneous Taxes on the eMARS upload procedures.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 06-REV-11: The Department Of Revenue Should Ensure That Administrative Fees Are Accurately Accounted For In The State's Accounting System (Continued)

Management Response and Corrective Action Plan

In the interim and prior to further UGRLT system automation, the Division of Miscellaneous Taxes will work with the Division of Operations to further refine the monthly email confirmation to ensure that all the steps necessary to move the administrative fees from monthly collections are timely executed in the proper sequence within the current system requirements.

FINDING 06-REV-12: The Department Of Revenue Should Continue With Initiatives To Eliminate The Crosschecking Backlog Of Motor Fuels Dealers

During our audit, we noted that the Department of Revenue's (DOR) Motor Fuels Tax Section has a large backlog in crosschecking motor fuels dealer reports. Each month fuel dealers and transporters file a report with the Motor Fuels Tax Section that provides details on the buyer, seller, and transporter for fuel bought and sold in Kentucky. Crosschecking these reports allows DOR to detect discrepancies in delivery dates and fuel quantities reported. This identifies likely candidates for an audit, which will lead to billing for additional taxes due if fuel deliveries were understated.

About 607 dealers filed monthly reports in FY 06 for a total of approximately 7,284 reports. The backlog was 28,064 returns at the end of FY 06, 26,921 as of June 2005, 26,232 in May 2004, all down from a high of 33,000 during the FY 03 audit. Motor fuel section staff members often perform a crosscheck at the same time they make an adjustment to a report, so some FY 06 reports have already been crosschecked. This suggests that the oldest unchecked reports could therefore be more than four (4) years old.

DOR appropriately gives processing activities its highest priority. Compliance efforts such as crosschecking are performed when trained staff members have time available. High turnover rates and difficulty in maintaining an adequate staffing level appears to have limited the time available for crosschecking, leading to a backlog.

Dealer and transporter reports may contain errors or omissions. Discovery of these errors during crosschecking may lead to an audit, resulting in the issuance of tax bills and increased revenue. Failure to crosscheck the reports promptly means that the Commonwealth may not be receiving all taxes timely.

Dealers are required to maintain their records for only five (5) years. Consequently, all dealer and transporter audits must be conducted within five (5) years of filing. The backlog, which grew during FY 06, already represents more than four (4) years. Additional loss of staff could stretch the backlog to five (5) years. Were this to happen, any additional tax due would become uncollectible.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 06-REV-12: DOR Should Continue With Initiatives To Eliminate The Crosschecking Backlog Of Motor Fuels Dealers (Continued)**

Dealers are required to maintain records for five (5) years. KRS 138.230 states:

Every dealer receiving gasoline or special fuel in this state shall keep, and preserve for five (5) years, an accurate record of all receipts and of all production, refining, manufacture, compounding, use, sale, distribution and delivery of gasoline and special fuel, together with invoices, bills of lading and other pertinent records and papers required by the Department of Revenue. Every person purchasing gasoline or special fuel from a dealer for resale shall keep, and preserve for a period of five (5) years, a record of all such gasoline or special fuel so purchased and sold or used, and the amount of tax paid to the dealers as part of the purchase price, together with delivery tickets, invoices, bills of lading and such other records as the department shall require.

In addition, KRS 138.347 states:

- (1) Each licensed gasoline and special fuel dealer shall, in accordance with the department's requirements, keep at his principal place of business in this state a complete record of all such gasoline and special fuel sold by him under gasoline refund invoices provided for in KRS 138.351, which records shall give the date of each such sale, the number of gallons sold, the name of the person to whom sold and the sale price.
- (2) Every person to whom a refund permit has been issued under KRS 138.345 shall, in accordance with the department's requirements, keep at his residence or principal place of business in this state a record of each purchase of gasoline and special fuel from a licensed dealer or the dealer's authorized agent, the number of gallons purchased, the name of the seller, and the date of purchase.
- (3) The records required to be kept under subsections (1) and (2) of this section shall at all reasonable hours be subject to inspection by the department or by any person duly authorized by it. Such records shall be preserved and shall not be destroyed until five (5) years after the date the gasoline and special fuel to which they relate was sold and purchased.

In effect, these statutes place a five-year limit on conducting audits of motor fuels dealers and transporters.

Good internal controls dictate that motor fuels dealer reports should be crosschecked timely for accuracy. This facilitates monitoring of taxpayer compliance, permits carefully targeted audits, and assures timely and complete tax collection. It also reduces the risk of becoming unable to collect tax because the taxpayer has gone out of business.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 06-REV-12: DOR Should Continue With Initiatives To Eliminate The Crosschecking Backlog Of Motor Fuels Dealers (Continued)**

Recommendation

The auditor recognizes that the Gasoline Tax Section has recently added personnel, which has caused a decrease in the backlog during fall 2006. Also, DOR has begun the process of purchasing a computerized crosschecking system. Bidding for the proposal closed November 1, 2006.

Revenue should:

- Proceed with implementation of the computerized crosschecking system.
- Manage the backlog so that no reports pass the five-year threshold for recordkeeping without being crosschecked.

Management Response and Corrective Action Plan

The Department of Revenue (DOR) agrees with the Auditor's findings and recommendations. The motor fuels tax compliance computer program contract is in the process of being awarded (pending negotiations). Implementation of this compliance (cross-checking) program will help manage and reduce the backlog because the data will be submitted electronically and the compliance effort will be performed in large part by the program. The additional staff assigned to this issue (as acknowledged by the Auditor) will continue to pursue the backlog periods as recommended by the Auditor.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2006

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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Reportable Conditions

(1) Audit findings that have been fully corrected:

FY 05	05-REV-2	The Department Of Revenue Should Ensure That All Penalties Are Distinctively Reported Into The Revenue's System	N/A	0	Resolved in FY 06.
FY 05	05-REV-3	The Department Of Revenue Should Strengthen Physical Securities	N/A	0	Due to improvements, this finding is downgraded to an Other Matter for FY 06. This finding is no longer required to be reported under <i>Government Auditing Standards</i> .

(2) Audit findings not corrected or partially corrected:

FY 05	05-REV-1	Electronic Payments To The Clearing Account Are Not Accurately Posted In Revenue's System	N/A	0	See 06-REV-1.
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(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings for this section.

(4) Audit finding is no longer valid or does not warrant further action:

There were no findings for this section.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2006

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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Material Weaknesses/Noncompliances

(1) Audit findings that have been fully corrected:

There were no findings for this section.

(2) Audit findings not corrected or partially corrected:

There were no findings for this section.

(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings for this section.

(4) Audit finding is no longer valid:

There were no findings for this section.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2006

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Other Matters</u>					
<i>(1) Audit findings that have been fully corrected:</i>					
FY 05	05-REV-4	The Department Of Revenue Should Establish Written Balancing Procedures For The Sales & Use Tax System	N/A	0	Resolved in FY 06.
FY 05	05-REV-6	The Department Of Revenue Should Ensure That All Agency Web Servers Have Updated Software And Security Patches Installed	N/A	0	Resolved in FY 06.
FY 05	05-REV-7	Computer Systems Should Be Updated To Remove System Limitations	N/A	0	Resolved in FY 06.
FY 05	05-REV-10	The Department Of Revenue Should Ensure The Late Transfers Of Motor Vehicle Usage Tax Are Being Thoroughly Tracked Or Penalized	N/A	0	Resolved in FY 06.
FY 05	05-REV-11	Motor Fuel Dealer Reports Should Be Processed Properly	N/A	0	Resolved in FY 06.
FY 05	05-REV-12	The Department Of Revenue Should Maintain Tax Returns In A Manner That Ensures Compliance With Confidentiality And Record Retention Laws And Ensure Accountability To Kentucky Taxpayers	N/A	0	Resolved in FY 06.
FY 05	05-REV-13	The Department Of Revenue Should Determine The Reason An Unhonored Check Processed Incorrectly And Fix The Problem	N/A	0	Resolved in FY 06.
FY 05	05-REV-14	The Department Of Revenue Should Strengthen Controls With The Compliance And Receivable System	N/A	0	Resolved in FY 06.
FY 05	05-REV-15	The Department Of Revenue Should Ensure Proper Cash Handling Procedures Are Being Followed	N/A	0	Resolved in FY 06.
FY 05	05-REV-16	The Department of Revenue Should Deposit Unidentified Payments More Timely	N/A	0	Resolved in FY 06.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2006

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Other Matters</u>					
<i>(1) Audit findings that have been fully corrected:</i>					
FY 04	04-REV-3	Computer Systems Should Be Updated To Remove System Limitations	N/A	0	Resolved in FY06.
FY 04	04-REV-6	Motor Vehicle Usage Receipts Should Be Timely Transferred Or Deposited	N/A	0	Resolved in FY 06.
FY 04	04-REV-8	The Department Of Revenue Should Determine The Reason An Unhonored Check Processed Incorrectly And Fix The Problem	N/A	0	Resolved in FY06.
FY 03	03-REV-11	Motor Vehicle Usage Receipts Should Be Timely And Properly Deposited With The State Treasurer	N/A	0	Resolved in FY 06.
FY 02	02-REV-2	The Kentucky Revenue Cabinet Should Update The Sales Tax Database And Automate Processing Of Accelerated Tax Returns	N/A	0	Resolved in FY 06.
FY 01	01-REV-1	The Revenue Cabinet Should Update The Sales Tax Database And Automate Processing Of Accelerated Tax Returns	N/A	0	Resolved in FY 06.
<i>(2) Audit findings not corrected or partially corrected:</i>					
FY 05	05-REV-5	The Department Of Revenue Should Ensure That All Open Ports On Agency Machines Have A Business-Related Purpose	N/A	0	See 06-REV-7.
FY 05	05-REV-8	Motor Fuels Dealer Reports Should Be Crosschecked For Accuracy To Ensure All Taxes Have Been Remitted	N/A	0	See 06-REV-12
FY 05	05-REV-9	The Department Of Revenue Should Consistently Process Local Distribution Journal Vouchers	N/A	0	See 06-REV-5
FY 04	04-REV-2	Motor Fuels Dealer Reports Should Be Crosschecked For Accuracy To Ensure All Taxes Have Been Remitted	N/A	0	See 06-REV-12.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2006

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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Other Matters

(2) Audit findings not corrected or partially corrected (Continued):

FY 04	04-REV-7	The Department Of Revenue Should Consistently Process Local Distribution Journal Vouchers	N/A	0	See 06-REV-5.
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(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings for this section.

(4) Audit finding is no longer valid or does not warrant further action:

FY 03	03-REV-6	The Kentucky Revenue Cabinet Should Develop Computer Applications To Streamline The Crosschecking Of Motor Fuel Dealer Reports	N/A	0	Five years have passed since the audit report in which this finding was submitted. A management decision has not been issued.
FY 02	02-REV-7	The Kentucky Revenue Cabinet Should Implement A System For Crosschecking Motor Fuels Dealer Reports	N/A	0	Five years have passed since the audit report in which this finding was submitted. A management decision has not been issued.
FY 01	01-REV-4	The Revenue Cabinet Should Implement A System For Crosschecking Motor Fuels Dealer Reports	N/A	0	Five years have passed since the audit report in which this finding was submitted. A management decision has not been issued.
FY 98	98-KRC-3	The Revenue Cabinet Should Ensure That Motor Fuel Reports Are Crosschecked As Required	N/A	0	Five years have passed since the audit report in which this finding was submitted. A management decision has not been issued.